

# **SOCIAL EXCLUSION AND RURAL UNDERDEVELOPMENT\***

Adolfo Figueroa  
Department of Economics  
Catholic University of Peru, Lima

This paper examines factors that explain social inequalities in the Third World. It develops a new theoretical approach, which focuses on social inequality and introduces the concept of social exclusion into the analysis. In so doing, it specially addresses the question: is inequality a result of some peculiar form of social integration, or rather a result of some exclusions taking place in the social process?

Social inequality is conceived in this paper in broader terms than income inequality. The social process is, for analytical purposes, divided into the three components: economic, political, and cultural. Social inequality refers to the aggregation of inequality on these components.

Social exclusion is also considered in a particular way. As a fact of life, we know that the same group of people who participate in some social relations may, at the same time, be excluded from others. Hence, to say that a person is excluded from something is a purely descriptive statement, with no analytical value. In analytical terms, the question is whether there are *some exclusions* that have important effects upon social inequality. Which are these exclusions in a particular society? *Who* is excluded and from *what*? *Why* do these exclusions take place?

## **Social Exclusion Theory**

This study deals with a society which is organized as a capitalist democracy, and which is over-populated in the sense that there is significant surplus labor. In this capitalist democracy, individuals participate in economic and social exchange endowed with a given set of assets. There are three types of assets: economic assets, which refer to productive resources, such as land, physical capital, financial capital and human capital; political assets, which refer to the access of people to the rights established by the society; and cultural assets, which refer to a system of social evaluations of the personal characteristics of individuals, such as their language,

---

\* Paper prepared for the World Bank Conference on Evaluation and Poverty Reduction, Washington, D.C., June 14-15, 1999.

race, sex, kinship, education, occupation, religion and geographical origin. The hierarchy of these values is established by the cultural values of the society. This society is thus socially heterogeneous.

While economic assets indicate what the person *has*, political and cultural assets indicate who the person *is*. In these terms, citizenship is a political asset; and the individual's personal characteristics (identity) are his or her cultural assets, which give the individual either social prestige or social stigma, leading to discrimination and segregation. Clearly, an individual with the same set of personal characteristics would have a different mix of cultural assets if the system of cultural values changed. Political and cultural assets are intangible; they are not tradable, so they do not have market values attached. However, as argued below, they play a significant role in the social process.

At any given point in time, individuals are endowed with different amounts of these assets. Economic inequality is the inequality in economic assets, whilst social inequality is a combination of inequality in economic, political and cultural assets.

A society where the only source of inequality is economic assets could be called a "liberal society". Political and cultural assets would be evenly distributed. In this society, "the only difference between the rich and the poor is that the rich have more money," as the famous dialogue between Fitzgerald and Hemingway goes.

*Exclusion from the political process*, in the context of democratic capitalism, means exclusion from citizenship rights. Democratic capitalism functions with a system of rights which, amongst other things, acts to set limits to the inequalities generated by the market system, and thus makes society viable. The factors which determine the set of rights in a particular capitalist democracy are various, including on the demand side: social pressure, tolerance to inequality, the culture of inequality, degree of democracy, and level of income amongst the poor; and on the supply side: the production capacity of the economy, the preference of the ruling classes to allocate scarce resources to the production of rights in the form of public goods, and international agreements. In the short run, State policy to manage aggregate demand is the most important variable explaining changes in the *effective delivery* of a given set of rights. Periods of economic growth will be favorable and periods of recession unfavorable.

All citizen rights are not universal, and even universal rights are not equally realized. When rights are non-universal, or when formally universal rights are not effective in practice, some people are excluded from some rights: participation in the administration of political power (the right to elect and be elected), the right to property, to justice, to social protection, and to basic services. Different categories of citizenship will then be created.

*Exclusion from the cultural process* has to do with the individual's exclusion from participation in particular social networks. Because of differences in cultural values, some people will be excluded from participating in some social networks of higher social value.

*Exclusion from the economic process* means exclusion from market exchange. Conventional economic theory assumes that all markets are "Walrasian," in the sense that individuals can buy or sell a good or a service as much as they want at the prevailing market price. In such markets, rationing operates through prices, and the amount to be exchanged is just a matter of money. In these markets no one willing and capable of buying or selling could be excluded from exchange. People may be excluded from exchange in some particular markets, but this is because their real income, or productive capacity, is too low. In conventional economics, the market system allows people free-entry and free-exit.

However, some markets operate with quantitative rationing. These "non-Walrasian" markets share the property that the expected *quality* of a commodity or service demanded or supplied is a function of its price. In this type of markets, some people will be excluded from exchange in spite of having sufficient real income or productive capacity. The economic literature suggests that the labor, credit and insurance markets may be "non-Walrasian". This is significant in that these markets can be regarded as *basic markets*, in the sense that they are fundamental for livelihood and security.

Exchange in non-Walrasian markets is carried out under conditions of imperfect competition and uncertainty, and it is then based on *promises* (to repay a loan, to work hard). In this context, asset endowments play a role in providing signals for the rationing process. Exclusions from non-Walrasian markets are not random; they depend upon the social asset endowment of individuals. Individuals who are poorly endowed with assets will be more likely to be excluded from basic markets. Also the individual's asset endowment will determine in which of the segmented markets he or she can participate.

In this society, the basic hypothesis is that the labor market (a non-Walrasian) operates as the primary mechanism of social exclusion. In this market, the following variables are determined: the quantity of wage employment, real wages, and profits. Given the labor supply, the total quantity of surplus labor is then determined.

In an over-populated economy, the amount of surplus labor takes the form of unemployment and self-employment. The incomes of the self-employment must be lower than wages. This income difference among workers is necessary for the functioning of the labor market because it creates an incentive system by which workers prefer and seek wage employment. The logical consequence is that those excluded from the labor market become the poorest. Among the surplus labor we also find superfluous labor.

Who are those excluded from the labor market? For a given type of labor, workers with the lowest cultural assets will be the most likely to be excluded. Social groups that belong to different subcultures inside the society will be viewed by employers as the least reliable workers. Due to language and cultural barriers, employers may also expect that the cost of extracting economic surplus from this type of labor will be higher. Thus through the workings of the labor market, people bearing a social stigma for the capitalist class will be placed at the bottom of the income pyramid.

Most of the surplus labor will also be excluded from the credit and insurance markets. Banks and insurance firms do not expect to make much profit by doing business with the excluded from the labor market, that is, with the rural or the urban self-employed. For the surplus workers, this is the secondary mechanism of market exclusion. They cannot escape becoming the poorest. Also, the surplus workers will be the most likely group to be excluded from political and cultural processes.

In sum, exclusion theory assumes a heterogeneous society. Individuals participate in market exchange endowed not only with different quantities of economic assets, as standard economic theories say; but also endowed with different quantities of political and cultural assets. There is a hierarchy of markets, where labor, credit and insurance markets play the most important role in the generation of income and its distribution. Neither all individuals are homogeneous, nor all markets play the same role. From the viewpoint of reproduction of inequality, the labor, credit and insurance markets can be called basic markets. Finally, governments have no incentives to change these initial endowments. It is politically more profitable to govern through clientelistic relations instead of simply establishing and securing economic rights. This set of assumptions constitutes exclusion theory.

An empirical prediction of exclusion theory is that today's inequality of a country will depend on its initial conditions. Its historical origin and its foundational shocks (colonial heritage, import of certain ethnic groups as slaves) are important. Countries that were "born" freer will be more homogeneous and more equal today than those that were "born" more heterogeneous and hierarchical. Because, rural incomes can explain a significant part of the overall income inequality we observe in Third World countries, an explanation of rural underdevelopment is a way to test exclusion theory. This will be done in the next sections.

## **Rural Underdevelopment**

Assume that part of the surplus labor takes the form of a peasant economy. Also assume that peasant households are endowed with the lowest amounts of economic, political and cultural assets in society.

The peasant household is defined as a unit that operates with family labor. It has small endowments of land, physical capital and working capital in relation to its labor force. It is relatively well endowed with labor. Its human capital endowments is, however, low relative to what is found in the capitalist economy. With these resource endowments, it does not have a capacity for savings or capital accumulation. The assumed economic logic of peasant households is the maximization of total family income.

The peasant economy constitutes the poorest segment of this society. But it should grow. Because the peasant economy operates within a dynamic capitalist sector where technological change and the appearance of new goods and new markets take place, there is much room for the peasantry to adopt those innovations. Actually, the peasant economy should grow at a faster rate than the capitalist sector does. Adoptions can be done at a higher speed than innovations. But this is not what we observe in the Third World. Here the peasantry is stagnant and gives rise to rural underdevelopment.

What factors hinder the economic growth of peasant households? In the literature various hypotheses have been developed to answer this question. The principal factors mentioned are education, lack of profitability, inappropriate supply of innovations, and cultural factors. In this paper I would like to develop a rarely examined hypothesis: social exclusion.

Assume that in the peasant economy the nature of technology is such that land, physical capital and working capital must be combined in fixed proportions. These factors are not substitutable one for the other. They are limitational factors. Physical capital and labor will be assumed to be imperfect substitutes.

Given its technological constraints, its factor endowments and its economic logic, the peasant household will seek to economize land, working capital and physical capital—the limitational factors—, which are its relatively scarce production factors. This implies it will maintain a balance between these factors in order to eliminate any excess supply or underutilization.

Because of this carefully balanced use of resources established by the peasant household over time, the current equilibrium is efficient. But it is a low-level equilibrium. Breaking out of this equilibrium is difficult for the peasant household needs to increase all its limitational factors. At the low-level equilibrium the peasant household does not demand credit to obtain working capital because it has nothing to gain if only credit increases. Nor is there a demand for credit to accumulate physical capital for the same reason. Even the demand for land will not be significant. (Observed peasant movements for land are either seeking to seize additional assets or trying to recuperate previously confiscated land. As agrarian reform programs have demonstrated, land redistribution is not a sufficient condition for raising the labor productivity of peasants.)

In the peasant economic logic of capital and land resource allocation, it is hypothesized that peasants have a level of human capital that is sufficient to manage current technology. Given this technology, they have neither excess nor a deficit in the supply of human capital.

The productive capacity of the peasant economy (i.e. its productivity) will expand with the adoption of innovations. Given current production practices, even if they could increase the scale of their operations, peasants could not increase their productivity. Schultz said that peasants are "poor but efficient," but in reality this is a performance that applies only within the context of a traditional and static economy (Figueroa, 1984).

Innovations in this study refer to the appearance of new production methods and new consumption goods. The appearance of new goods gives rise to the creation of new markets.

Increased human capital permits the individual to adopt innovations in a faster and cheaper manner. The individual can understand new practices and organizations that bring innovations. A person's capacity to adapt to innovations depends on the human capital of the individual (Schultz, 1977). However, if there are no innovations available to adopt high levels of human capital may have little economic value. On the other hand, individuals may not adopt innovations due to a lack of human capital.

Human capital is a restriction that operates solely in a dynamic context. In a static world it plays no role. In a dynamic world human capital may become a constraint. But the accumulation of human capital requires financing.

Given an exogenous supply of innovations, financing limits development of productive capacity. The peasant economy's development is limited by the lack of financing for the various types of capital expansion needed to adopt innovations: working capital, physical capital, and human capital. The peasant economy is not restricted in its development by one sole limitative factor.<sup>1</sup> There are various limitative factors. But all of them can be reduced to one single factor: the lack of financing.

---

<sup>1</sup> Following Georgescu-Roegen (1967), we may say that a factor is limitative when its increase is a necessary and sufficient condition for increasing production. This indicates that the other factors are redundant, they are in excess supply in relation to the limitative factor. A factor is limitational when its increase is a necessary but not a sufficient condition for increasing the quantity produced. This indicates that this factor can not be substituted for the other factors of production. While the limitational character of a factor of production reflects the nature of technology, the limitative characteristic reflects the firm's factor endowments.

With the adoption of innovations the peasant economy will be able to increase its productivity. As a consequence, it will have the capability to take out and pay back loans. Peasant households will become recipients of credit. But, under current conditions, these households can not obtain credit via the credit market. And due to this limitation they can not increase their productivity. Thus, a vicious circle of poverty is created. A key question is why the market mechanism has not resolved this problem?

An answer is offered by the recent development theory. In intuitive terms, it can be expressed in the following manner. The introduction of an innovation in a rural zone generates new markets for the products used by the innovations, which we may call primary goods. But markets for the primary and complementary industries may not establish themselves. The prices at which firms would tend to offer these primary and complementary goods will be very high due to the small scale of the initial demand. Supply and demand curves will not meet. These high prices constitute the "start-up" costs for rural development (Ciccone and Matsuyama, 1996).

If these markets do not establish themselves, the innovations likewise will not take place and peasants will remain in the trap of underdevelopment. The peasant economy is poor because markets are underdeveloped, and the markets are underdeveloped because the peasant economy is poor.

The introduction of innovations such as fertilizers, pesticides and herbicides, will create the development of markets for those goods. But that will require the development of complementary goods such as credit and technical assistance. If the size of the market is small, the markets for the primary and complementary goods will not develop. And if these markets do not develop, the innovations will not flourish.

In the case of the peasant economy operating in the context of developed markets, capitalist development will generate positive externalities for the adoption of innovations, such as information, demonstration, development of primary and complementary markets. It will be possible for the peasantry to adopt the innovations and gain access to all markets including the credit market. The peasant household could become a capitalist enterprise. Nevertheless, the credit market excludes the peasant households due to their small size. At their scale of operation it is not profitable for banks to make business with them. Other sources of credit will be available that include the capitalist agro-industrial firms. But they will be tied credit, principally short term, for working capital only, and will be rationed.

If the peasant economy functions in the context of underdeveloped markets, with little market penetration, these positive externalities will not operate. The costs of information and learning will be high and the markets associated with innovation will not exist. Financial capital will come from the small savers in the rural milieu. But these savers will not be willing to give up the use of these funds for long

periods. The loans will be short term and in small amounts. The peasant economy will remain deprived of the adoption of innovations.

In both cases, the peasant economy will not achieve its development in spite of the existence of innovations. This will constitute a market failure.

Peasant households can escape this trap, in both contexts, if they receive exogenous financing in order to accumulate physical and human capital. This intervention will set into motion the development process. Peasant household will be able to increase their productivity, will become recipients of credit, and will be integrated into new markets. In this process they will transform themselves into capitalist firms.

The limitative factor in the development of the peasant economy is financing. The initial factor endowments are exogenous, but the current quantities of working capital and physical and human capital are endogenous. The fundamental exogenous factor is financing outside the credit market. In the first stage of development, the financing must be exogenous. Only later will financing be endogenous, through the development of credit markets, and development will proceed in an accumulative manner.

Further, financing for the provision of public goods is necessary. The quantity of public goods is an exogenous variable in the production function. The building up of human capital through public educational and health services is one of the principal mechanisms that connect public goods to the increase in productivity. Public goods also have a positive effect on the development of markets. Transportation and communications infrastructure reduces transaction costs. Public goods do not come from private investment but rather principally from state investment and their financing is likewise exogenous.

The financing of the development of the peasant economy in its initial stages is therefore exogenous. These financial resources must be supplied by the state. Hence, rural underdevelopment is the result of state failure as well.

The sequence of development is first public financing and later market based financing. Productivity and private profitability are established, in the initial phases, with public financing. Banks will come later once viable recipients of credit have emerged.

In the economics literature, as reviewed by Levine (1997), there are diverse points of view concerning the relationship between financing and growth. For some, such as Joseph Schumpeter, the development of banks precedes growth. For others, such as Joan Robinson, banks follow growth. For modern economists such as Robert Lucas, financing does not have an importance on growth, only real factors matter. Development economists, on the other hand, have simply ignored the issue. The theory adopted in this study is that banks come after the initial growth take-off and



that in the initial and take-off stage it is exogenous financing outside the financial markets –state financing– that is crucial.

## **Empirical Evidence**

The theory of start-up costs predicts that rural areas where incomes are higher are those that have a larger stock of public goods. This empirical prediction seems to be consistent with data of Third World countries. No statistical data can be shown here but one observes that rural areas are heterogeneous in their levels of income; the presence of public goods is also unevenly distributed in rural areas; moreover, these variables tend to be positively correlated. The link of start up costs and exclusion theory is that the lack of public goods in peasant areas is the reflection of political exclusion.

Several studies on small farming have found that the adoption of technological innovations depends on the level of education of farmers. If this level is beyond a threshold of number of years of schooling, farmers will adopt and adapt innovations, but the proportion of farmers having this level of schooling is very small (cf. Figueroa 1986). This is also consistent with one of the predictions of exclusion theory. It is not only the problem of a limited supply of public education services in rural areas, but also the problem that cultural segregation makes learning at school more costly for peasants.

Bank credit excludes most of the peasantry. Banks set thresholds of land size to select farmers who can be eligible for credit. Peasants are financed through the informal credit markets and through social networks. This is consistent with another prediction of the theory.

The general observation is that the backward rural areas are relatively poor in public goods; these are also areas where markets in general—and credit market in particular—are less developed, education levels are lower, technology is more traditional and income levels of people are lower. This general observation fits very well the empirical predictions of the theory. Backward rural areas can be seen as cases of low-level equilibrium.

Hence, rural backwardness is the result of both market and state failures. The peasantry in general is excluded from the market and from state policies. Why is it that the state does not finance the start-up costs needed for rural development? Why is it that market relations leave peasants out? At the bottom of these failures lies the problem of social exclusion. If it were not for social exclusion theory, it would be very difficult to explain productivity stagnation in the peasant economy that operates

within a dynamic capitalist economy. Social exclusion theory attempts to explain inequality by looking at the performance of institutions.

According to exclusion theory, the rural poor are not only people whose incomes are low, but also are different people. They are poorly endowed with economic, political and cultural assets in the context of a capitalist society. Peasants are excluded from the basic markets. Joan Robinson's well-known dictum "The only thing that is worst than being exploited is not being exploited" applies very forcefully to them. Peasants are excluded from labor and credit markets, the two mechanism under which workers can be exploited, as Roemer (1982) has shown. Thus, the peasantry makes up the "hard core" of exclusion and poverty in a heterogeneous society.

Another empirical consistency of exclusion theory comes from the fact that countries that are multiethnic and multicultural show a higher degree of inequality. Countries that were born freer—that is, as more homogenous societies—show lower degrees of inequality. The fact that Latin America is the most unequal region of the world (Deininger and Squire 1996); and the fact that within Latin America, countries that are more heterogeneous in terms of multi-ethnic and multi-cultural traits are more unequal (Figueroa 1999) are both consistent with the predictions of exclusion theory.

## **Policies and Project Evaluation**

Given the empirical consistency of the theory of social exclusion, one is allowed to use this theory to discuss economic policies. Rural development can be achieved if the mechanisms of social exclusion are eliminated or weakened.

Rural development is a massive endeavor. It is not a question of reaching pockets of poor peasants. For a massive action, there exist only two channels: the market system and the state. But the development trap is a result of, precisely, market and state failures. We cannot expect rural development if the market and the state operate under the same logic. The policy principle would be to resolve market and state failures. This implies the generation of innovations directed to alter the mechanisms of social exclusion. These innovations refer to changes in the technology of production of new goods and in the technology to produce new institutions.

The expansion of the so-called civil society, or the Third Sector, seems to be the result of these market and state failures. This is clear in the case of NGO's in rural areas. But there are also indications of failures in this sector. NGOs seek to be successful with their own projects. This seems to be their economic logic. This logic sets restrictions to the use of these projects as mechanism to generate innovations.

But innovations are not free goods. They must be produced. Therefore, they also have a technology of production and costs of production. This technology needs improvements as well. Technologies to produce innovations—technologies to produce technologies, the meta-technology—need to go through a process of innovations. In short, innovations need financing.

What type of innovations should be financed if the objective is to resolve institutional failures? This is a problem that project designers and project evaluators must help to resolve. This problem is—I believe—quite different from the standard one, where the institutional context is taken as given, and where institutional failures are ignored, including here the social exclusion mechanisms.

## BIBLIOGRAPHY

Ciccone, Antonio y Kiminori Matsuyama.

1996 “Start-up Costs and Pecuniary Externalities as Barriers to Economic Development.” Journal of Development Economics, Vol. 49, pp. 33-59.

Deininger, Klaus and Lyn Squire

1996 “A New Data Set Measuring Inequality”. The World Bank Economic Review, Vol. 10, No. 3, September.

Figueroa, Adolfo

1984 Capitalist Development and the Peasant Economy in Peru. Cambridge University Press.

1986 Educación y productividad en la agricultura campesina de América Latina. Rio de Janeiro: Publicaciones ECIEL.

1999 “Social Exclusion as a Distribution Theory”. Paper prepared for the workshop Social Exclusion and Poverty Reduction in Latin America, organized by the World Bank, Washington, D.C., May 26-27.

Georgescu-Roegen, Nicholas

1967 Analytical Economics. Harvard University Press.

Levine, Ross

1997 “Financial Development and Economic Growth.” Journal of Economic Literature, Vol. 35, June, pp. 688-726.

Roemer, John

1982 A General Theory of Exploitation and Class. Harvard University Press.

Schultz, Theodore

1974 “Education and the Ability to Deal with Disequilibria”. Journal of Economic Literature, Vol. 13.